NO._____

IN THE

Supreme Court of the United States

OCTOBER TERM, 1941

TERRY THOMPSON, ET AL., INDEPENDENT EXECUTORS OF THE ESTATE OF J. T. SNEED, JR., DECEASED,

Petitioners.

vs.

GUY HELVERING, COMMISSIONER OF INTERNAL REVENUE,

Respondent.

Brief in Support of Petition for Writ of Certiorari to the Circuit Court of Appeals for the Fifth Circuit.

OPINIONS BELOW

The original opinion of the Circuit Court of Appeals is reported at 119 Fed. (2d) 767; the opinion on rehearing at 121 Fed. (2d) 725. The opinion of the Board of Tax Appeals is reported at 40 B. T. A. 1136.

JURISDICTION.

The judgment of the Circuit Court of Appeals was entered May 5, 1941 (R. 95). Petitioners' Motion for

Rehearing, seasonably filed, was denied on July 17, 1941 (R. 106). The jurisdiction of this Court is invoked under Section 240(a) of the Judicial Code, as amended by the Act of February 13, 1925.

STATUTES INVOLVED

Pertinent Statutes and Regulations appear in the Appendix, page 49 infra.

QUESTIONS PRESENTED

Can a portion of certain sums which Petitioners' decedent (Sneed) received in *1926*, and of which he then and thereafter had unqualified ownership and possession, without obligation or liability to anyone, be treated as a part of his taxable income in *1936*, even if:

(a) The total sums received in *1926* were paid to Sneed as bonuses for various oil and gas leases which he made in that year on various portions of a ranch owned by him;

(b) He obtained in *1926* an allowance for percentage depletion with respect to all of these bonuses;

(c) Certain of these leases lapsed in *1936* without development upon the areas covered by the lapsed leases, although the substantial mineral reserves underlying the lapsed lease areas had been partially depleted by production from other wells on the ranch from which Sneed received royalty income; and

(d) The sum included in 1936 income represented the percentage depletion allowed with respect to the bonuses received in *1926* for the leases which so lapsed?

STATEMENT

The statement of facts contained in the petition for certiorari (pp. 3 to 6, supra) sufficiently develops the salient facts. Reference to that statement is respectfully made.

SPECIFICATION OF ERRORS TO BE URGED

The Circuit Court of Appeals erred:

(1) In holding that Sneed received income in 1936 in an amount equal to the 1926 allowances for percentage depletion, when oil and gas leases made in 1926 lapsed without production from the leased areas.

(2) In holding that taxing such amount as 1936 income was not contrary to the constitutional and statutory provisions defining income and requiring the calculation of taxable income upon an annual basis.

(3) In holding that Sneed took the 1926 depletion allowances upon condition that they be restored to income when and if it was determined that there would be no production from the particular lease for which the bonus was paid.

(4) In holding, in view of the undisputed fact that the gas reserves in each of the areas covered by the twenty-six leases had been actually depleted, that the amount of the 1926 depletion allowances should be included in Sneed's income in 1936.

(5) In holding, it being conclusively established that there would be production subsequent to 1936 from the twenty-six areas and the 1926 bonuses having

been "income from the property," that the 1926 depletion allowances should be restored to income in 1936.

(6) In refusing to hold that Sneed's entire ranch was one "property," in applying the principle that bonus depletion allowances cannot be restored if the "property" has been depleted during the life of the lease.

SUMMARY OF ARGUMENT

I.

There is no statutory provision or regulation which supports the Respondent's action in including in Sneed's 1936 income the restored depletion here in question. The Regulations relied upon are not applicable and the *ex post facto* rulings of the Respondent's Chief Counsel are of no moment.

II.

In the absence of a statute or regulations supporting the Respondent's action, the controlling test to determine whether this item of restored depletion can be included in Sneed's gross income for 1936 is whether he received, or there accrued to him in 1936, gross income on that account. If not, he cannot be taxed upon it. Admittedly Sneed actually received nothing. No gain accrued to him in 1936. The entire amount of the bonuses was gross income to Sneed in 1926. He was never under any obligation or liability with respect to these bonuses, and therefore could be relieved of none. The depletion allowed him in that year was allowed unconditionally as a matter of legislative grace and

as a deduction from gross income. It is incorrect to say that any gross income went untaxed in 1926.

III.

Even if gross income went untaxed in 1926, it is improper to attempt to correct this alleged error by adding an equivalent amount to gross income for 1936. The general statutes of limitation applicable to tax cases, the limited scope of section 820 of the Revenue Act of 1938 dealing with the mitigation of the effect of Statutes of Limitation in certain income tax cases, and statutory provisions regarding the extent to which percentage depletion previously allowed is to be considered in determining gross income, show that Congress never intended that percentage depletion allowed in 1926 be included in gross income for 1936 under any conditions whatsoever. The same result is supported by controlling decisions of this Court.

IV.

It is established that percentage depletion based upon an oil and gas lease bonus cannot be restored to income when the lease terminates if there has been any production whatsoever from the property. Under applicable Regulations and within the intendment of Congress, Sneed's entire ranch was one property, which was substantially depleted during the ten year life of these leases. These principles are peculiarly applicable to gas properties. So, under the particular circumstances present here, the restoration to income was improper, regardless of the rule which might be generally applied.

V.

This Court's decision in *Herring v. Commissioner*, 293 U. S. 322, requires that the aggregate depletion allowances to be allowed a lessor equal 27½ per cent of the lessor's entire gross income from the property over its life, limited only by the statutory provision that this allowance can in no year exceed 50 per cent of his net income from the property. This case also holds that these percentage depletion allowances can only be made in the year gross income is received and are not to be denied because no actual depeltion occurred in that year. In view of the established facts that, through the making in 1936 of new leases for cash bonuses, Sneed received in 1936 gross income from the lapsed-leased areas, and that he would subsequent to 1936 receive further income through production from these areas, an application of the principles enunciated in the *Herring* case require a holding that the 1926 depletion allowances were erroneously restored to income in 1936.

ARGUMENT

I.

Neither the Respondent nor the Court below asserts that there is, or has ever been, any statutory provision dealing with the restoration to gross income of percentage depletion previously allowed with respect to a bonus. Instead, the Respondent predicated his action upon *Article 216(d) of Regulations 69* (1926 Act), *Article 23(m)-10(c) of Regulations 94* (1936 Act) and *G. C. M. 14,448* (C. B. XIV-1, p. 98), and it appears that the Court below adopted the same view.

G. C. M. 14,448 merits no consideration. It was promulgated in 1935, more than nine years after Sneed had received the bonuses and claimed depletion thereon, and subsequent to this Court's opinion in *Herring v. Commissioner*, 293 U. S. 322, decided December 3, 1934. Although Sneed's 1926 tax case, involving primarily the depletion question, had been decided adversely to him in June of 1934 (30 B. T. A. 1121), prior to this Court's decision in the Herring case and the Board did not reconsider the matter and grant the allowance, as required by the Herring case, until November 15, 1935 (33 B. T. A. 478), it attached no condition to the allowance and did not give consideration to *G. C. M. 14,448*. This Counsel's Memorandum is clearly *ex post facto*. *Cf. Helvering v. Reynolds Tobacco Company*, 306 U. S. 110, and, since it is not an official regulation, is entitled to no particular consideration. *Helvering v. New York Trust Company*, 292 U. S. 455, 468.

If support can be found for the Respondent's action, it must come from the Regulations cited by the Respondent in his deficiency notice.

In dealing with these Regulations, certain basic principles should be borne in mind. One of these has to do with the capital which Sneed had in the mineral reserves under his ranch. We think it clear that from an income tax standpoint capital is cost, or value as of March 1, 1913, if the property was then owned by the taxpayer and is not value at any particular time. If this were not true, then the sale of property at its value would never produce income, but would merely convert capital from one form into another. Under these

principles, Sneed had no capital in the mineral reserves under his ranch for he had acquired them long before the presence of these reserves was suspected, and it is an established principle that in such a case no part of the cost of the land can be allocated to mineral reserves ascertained to exist subsequent to purchase.[1] To illustrate: If Sneed had sold outright the entire mineral content of his ranch in 1925 or 1926, after this mineral reserve was known to exist, he could not have deducted anything from the selling price in order to arrive at his taxable gain because these mineral reserves had no cost — he had no capital in them.

Another factor applicable in considering the Regulations is that an oil and gas lease bonus differs materially from minimum royalties frequently paid under hard mineral leases. A minimum royalty is payment in advance for a specified quantity of mineral to be subsequently extracted.[2] The bonus for an oil and gas lease, although an advance royalty and "gross income from the property" for tax purposes, is not applicable to any specific quantity of oil or gas. No matter how large the bonus, the specified *ordinary* royalties are payable for every barrel or cubic foot of oil or gas extracted. That is true generally, and it is true under the terms of Sneed's particular leases.[3] A bonus pays the advance royalty on whatever quantity of oil or gas the lessee may extract, whether it be one foot of gas or billions of feet.

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[1]Reg. 69, Art. 201, Now Reg. 103, sec. 19.23(m)-2.

[2]This factor distinguishes and renders inapplicable Lamont v. Commissioner, 120 Fed. (2d) 996, discussed infra, p. 30.

[3]R. 75.

Closely connected with the foregoing is the principle accepted by the Respondent and established by a Board of Tax Appeals decision that even if an insignificant amount of oil or gas is extracted by the lessee, no portion of the depletion allowed with respect to the bonus paid for the lease can be restored to the lessor's income when the lease terminates.[4]

From 1918 until the present time there have been extant Treasury Regulations dealing with depletion upon bonuses and advance royalties. There is an important difference between those promulgated prior to the 1926 Act (when percentage depletion was first provided for as a substitute for discovery depletion) and those promulgated under the 1926 and subsequent acts. The earlier pre-1926 Regulations will be first considered.[5] These Regulations provided for an allowance for depletion to a lessor who received a lease bonus or an advance royalty, and then provided that upon the termination of the lease "without the removal of any or all of the mineral contemplated by the lease" the lessor should restore to "capital account" so much of the depletion previously deducted as was "in excess of the actual depletion or loss in value sustained as a result of the operations under the lease, and the corresponding amount will become income in the year in which the lease expires, terminates or is abandoned."

Assuming the validity of these Regulations, despite the fact that they were held invalid by the Board of Tax

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[4]Dolores Crabb et al., 41 B. T. A. 686, in which respondent acquiesced, 1940-2 C. B-2; G. C. M. 14,448 discussed supra, p. 23.

[5]Art. 215(d), Reg. 62 (R. A. 1921); Art. 216(d), Reg. 65 (R. A. 1924), Appendix B, p. 51, infra.

Appeals in two cases — *Knapp*, 7 B. T. A. 790, and *Cooper*, 7 B. T .A. 798, decided in 1927, and that the Respondent acquiesced in these decisions and kept his acquiscence in effect until the latter part of 1933,[6] it is clear that so much of the Regulations as dealt with the restoration of bonus depletion previously allowed *referred only to depletion allowed against the capital which the lessor had in the reserves.* The Regulations throughout speak of "capital" and "capital account" an to "adjustment of capital account." These phrases are applicable to depletion based on cost or value as of March 1, 1913, but they have no application whatsoever to depletion based upon discovery value (the third basis for depletion prior to the time percentage depletion was substituted therefor by the 1926 Act), because as heretofore pointed out value at any particular date is not capital either in common understanding or for tax purposes. Another reason why the Regulations, as they existed prior to the 1926 Act, had no application to discovery depletion is because discovery depletion was only applicable when there had been a discovery of oil with production. As above pointed out, when there has been production of oil or gas, even though small in amount, it is established that no part of the depletion allowed with respect to a bonus can be restored to income when the lease terminates.[7]

Thus, until the Revenue Act of 1926, the Regulations only required the restoration of depletion allowed with respect to a bonus or an advance royalty when the les-

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[6]Acquiescence withdrawn: Knapp, VII-1 C. B. 17; Cooper, VII-1 C. B. 7.

[7]Note 4, supra.

sor had capital invested in the lease, and limited that restoration to the amount by which depletion previously allowed exceeded "actual depletion or loss in value sustained as a result of operations under the lease."[8]

The percentage depletion provisions contained in the Revenue Act of 1926 and later Acts were a substitute for discovery depletion.[9] Regulations 69, promulgated under the 1926 Act, continued, in sub-paragraphs (a) to (d), both inclusive, of Article 216, the substance of the earlier Regulations with respect to depletion on bonuses or advance royalties which has just been discussed, and added thereto to cover the percentage depletion provisions of the 1926 law the following sub-paragraph (e):

> "In lieu of the treatment provided for in the above paragraphs, the lessor of oil and gas wells may take as a depletion deduction in respect of any bonus, royalties, and other income from the property in the taxable year 27½ per cent of the amount thereof, but the deduction shall not exceed 50 per cent of the net income (computed without allowance for depletion) from the property."

It is the present position of the Respondent, and the position taken in G. C. M. 14,448, that the earlier subdivisions of the Article which contain the above quoted provision, insofar as they deal with the restoration of depletion previously allowed, are applicable to percent-

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[8]Arts. 215(d) and 216(d) of Regs. 62 and 65, supra, Note 5, Appendix, p. 51.

[9]Cf. Report, Ways & Means Committee (69th Cong. 1st Sess. H. Rept. 1); Report, Senate Finance Committee (69th Cong., 1st Sess. S. Rep. 52).

age depletion. But it is obvious that this position is only an afterthought, for in the *Herring* case heretofore dealt with, and in *Sneed's* own 1926 case, the Bureau of Internal Revenue strenuously contended that no depletion could be allowed with respect to a bonus, unless there had been actual production from the property, and it was then, and is now the rule that if there had been actual production from the property under the lease no part of the bonus depletion could be restored to income.[10] So the essence of Respondent's present position, and the position taken in G. C. M. 14,448, is that in promulgating the 1926 Regulations, and in all Regulations prior to this Court's decision in the Herring case, the Treasury Department was carefully providing for the restoration of an allowance that they believed and strenuously contended was never allowable in the first instance.

Not only this, but subdivision (e) of Article 216 of Regulations 69 above quoted contains nothing whatsoever as to the restoration of percentage depletion, but it does say that the provisions of that Article are "in lieu of the treatment provided for in the above paragraphs," which above paragraphs are the only ones which deal with the restoration of depletion under any circumstances whatsoever.

The only answer which Respondent has ever been able to make about this is contained in G. C. M. 14,448, which says, in substance, that the allowance for bonus depletion, which Herring, Sneed and others similarly situated finally obtained after prolonged contests with

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[10]Authorities cited Note 4, Supra, p. 25.

him, was obtained upon condition that it be restored. The Court below, however, was able to torture this meaning out of the quoted phrase beginning "in lieu":

> "This amounts to saying that (e) is in lieu of (a), (b), (c) and (d) *perhaps so far* as it speaks of a capital account, but not so far as restoration to income is concerned."[11]

This, we submit, is an entirely insupportable construction of the plain phrase "in lieu of the treatment, etc." The error is so clearly pointed out in Judge Hutcheson's dissenting opinion in the *Crabb* case[12] that we will not discuss it further.

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[11]The lower court said: "It is argued that while the cost or discovery value basis deduction is and has always been subject to (d) above quoted, the meaning of (e) is that the percentage deduction is absolute and final. The Commissioner's General Counsel did not think so when he ruled upon the matter in 1935, after the decision in the Herring case (XIV-1 Cum. Bul. p. 98); but he held that the meaning of the Herring case, in connection with Murphy Oil Co. v. Burnet, 287 U. S. 299, which dealt with a cost-basis depletion allowance, and referred with approval to the Regulations under discussion, was that the deduction was the same in nature and purpose however measured, and the Regulations meant to treat them alike when the lease ended without production." The Murphy Oil Company case involved the Revenue Act of 1918, and the Regulations promulgated thereunder, and had nothing whatsoever to do with percentage depletion nor restoration of depletion; the reference in the Murphy case was not an approval of any regulation, but merely an explanation; in that case the question was primarily whether bonus payments were subject to depletion. Moreover, the Murphy case was decided long before the Herring case, in which decision of the question here involved was expressly left open.

[12]Crabb v. Commissioner (C. C. A. 5, 1941), 119 Fed. (2d) 772, Appendix, p. 55, infra.

There is a sound basis in fact and in law for the conclusion that Paragraph (d) of *Article 216, Regulations 69,* providing for restoration of depletion, was not intended to have application, and in fact does not have application, to instances of percentage depletion. And, parenthetically, the matter to be discussed distinguishes the present situation from that in *Lamont v. Commissioner of Internal Revenue* (C. C. A. 8th, 1941), 120 Fed. (2d) 996, where the taxpayer deducted depletion based on March 1, 1913 value on a total of 581,301 tons of iron ore on which minimum royalties had been received during prior years of the lease; the Commissioner determined that the depletion so deducted on unmined ore should be restored to income in the year the iron lease was cancelled. Cost or March 1, 1913 value are elements taken into consideration in determining gain or loss when property is sold, abandoned or destroyed. Any cost or March 1, 1913 value not previously recovered by depletion can always be recovered in case of subsequent production. Thus when bonus depletion allowed upon cost or March 1, 1913 value is restored to capital account, the lessor is not denied depletion upon or recovery of that much of the restoration. If he makes a new lease he can use the restored capital as the basis for depletion upon bonuses or royalties received under the new lease; if he disposes of the property the restored capital is recovered by being deducted from the selling price; if the property is abandoned the restored capital is charged off as a loss. But not one of these factors is present in the case of percentage depletion. No matter how much the property may produce subsequent to the termination

of the first lease, if the Respondent is correct in his present position, then his theory irretrievably deprives the lessor of a portion of the statutory depletion allowance, for percentage depletion cannot be restored to capital account. Once an effort to restore is successful, the allowance is gone forever. Returning depletion based upon cost or March 1, 1913 value to capital account is *restoration;* the same thing with regard to percentage depletion is *deprivation.* Thus the reason that subdivision (e) of Article 216 of Regulations 69 is really *in lieu* of the preceding subdivisions of the article, including (d) — which provides for restoration of depletion — becomes crystal clear.

It is submitted, therefore, that there is not, and has never been, any statutory provision or Treasury Regulation purporting to require a lessor, who is allowed percentage depletion upon an oil and gas lease bonus, to restore any part of that depletion to income under any circumstances whatsoever.

II.

Since the decision below cannot be supported by express statutory provision or Treasury Regulation, it must be supported, if at all, by the general provisions of the Revenue Act of 1936 defining the income taxed to individuals by that Act. That Act levies a tax "for *each taxable year* upon the net income of every individual."[13] It defines net income as gross income less authorized deductions, and provides, in *section 42*, that "the amount of all items of gross income shall be included in the gross income for the taxable year in

[13]Sec. 11, R. A. 1936.

which received by the taxpayer, unless, under methods of accounting permitted under *section 41* any such amounts are to be properly accounted for as of a different period." The methods of accounting required by *section 41* are: "The net income shall be computed upon the basis of the taxpayer's *annual accounting period* * * * in accordance with the method of accounting regularly employed in keeping the books of such taxpayer; but if no such method of accounting has been so employed, or if the method employed does not clearly reflect the income, the computation shall be made in accordance with such method as in the opinion of the Commissioner does clearly reflect the income."

This Court has heretofore dealt with the same, or corresponding provisions, in revenue legislation on many occasions, and has applied them in a way diametrically opposed to the holding of the Court below. The rules announced by this Court may be thus summarized:—receipt of income or accrual of the right to receive it within the tax year is the test of taxability; and all calculations of net and gross income must be made upon the basis of the statutory tax year. *Guaranty Trust Company v. Commissioner*, 303 U. S. 493, 498; *Burnet v. Sanford & Brooks Company*, 282 U. S. 359, 363; and *Burnet v. Thompson Oil & Gas Company*, 203 U. S. 301, 306, are sufficient support for this statement.

Therefore, we confidently assert that Sneed cannot be taxed upon the restored depletion in 1936, unless he received income within that year, or the right to receive it accrued to him. The fact that the leases terminated in 1936 merits no consideration. It was not

the basis of the Respondent's determination.[14] If that was the measure of Sneed's income, it would be limited to the value of those lapsed leases in 1936, which value he immediately realized by making new leases for bonuses which he reported as gross income and, as the Court below said "in truth he got nothing back; the lease simply perished according to its original terms."[15]

Of course the cash bonuses were gross income to Sneed in 1926 in accordance with this Court's decision in the *Harmel*[16] and *Herring* cases, but these bonuses — cash — were received by Sneed as his own property unconditionally, without limitation or liability to anyone in 1926, and, for aught this record shows, they might have been spent many years prior to 1936. The fact that they were gross income to Sneed in 1926, instead of supporting the Respondent's position, demonstrates conclusively that they could not be gross income in 1936.

Nor can it be said, even if it were controlling (but as to this see page 37, infra), that any portion of these bonuses were unreported in 1926 or untaxed in that year. Sneed reported all of the bonuses as a part of his gross income. He took deductions from that gross income in accordance with the statute as construed by this Court in the Herring case, but that no more supports the assertion that the bonuses were not taxed in 1926 than would the fact that Sneed reduced his tax liability by claiming a personal exemption as the head

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[14]Deficiency notice, R. 14.

[15]R. 89.

[16]Burnet v. Harmel, 287 U. S. 103, 53 S. Ct. 74.

of a family, or that he might have deducted any losses, which he had sustained, from his gross income from bonuses. Depletion allowances are not exclusions from gross income, but statutory deductions allowed as a matter of congressional grace.[17]

The most plausible support for the Respondent's position is derived from those cases which hold that the recovery of a bad debt previously charged off, the retirement of an obligation at less than its issuing price, the forgiveness of an indebtedness, the recoupment of a previously deducted expense or tax, or the avoidance of a previously accrued expense or tax, or the freeing of reserves from their offsetting liability produce taxable income when the event happens. But there is no real analogy between those situations and the one under consideration. This Court's decision in *United States v. Kirby Lumber Company*, 284 U. S. 1, and *Maryland Casualty Company v. United States*, 251 U. S. 342, are the leading cases of the type upon which the Respondent must rely here. But the controlling factors in these cases, and in all other similar cases, are that there was either an actual receipt of something within the tax year which had no basis in the recipient's hands because of previous deductions from income, or there was an actual enhancement in wealth realized through the freeing of the taxpayer from enforceable liabilities.

In the *Kirby Lumber Company* case in which the corporation had repurchased its bonds at a discount, this Court said:

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[17]Anderson v. Helvering, 310 U. S. 404, 60 S. Ct. 952; Helvering v. Bankline Oil Co., 303 U. S. 362, 58 S. Ct. 616.

"As a result of its dealings it made available $137,521.30 assets *previously offset by the obligation of bonds now extinct.* We see nothing to be gained by the discussion of judicial definitions. The defendant in error has realized within the year an accession to income, if we take words in their plain popular meaning, as they should be taken here."

In the *Maryland Casualty Company* case, which dealt with insurance reserves, the Court emphasized that the excess in the reserves upon which the tax was based "*was released to the general uses of the company and increased its free assets in 1913*" the year in which it was sought to be taxed. There is nothing similar in the instant case. None of Sneed's obligations were extinguished in 1936. No asset which Sneed had was made more available to him in 1936 than it was in previous years. There was nothing which met either the statutory conception of realization of income within the taxable year, or the popular meaning of these words.

An examination of all of the cases[18] cited by the Court below upon this point will clearly reveal that none is applicable here because of the factors just discussed.

The error in the statement of the Court below that "but where the return is correct on the facts, as they were when it was made, but occurrences in a later year alter the case, the adjustment is generally to be made in the later year" is conclusively shown by the practice consistently followed in closely analogous sit-

[18]See cases cited R. 93.

uations which have arisen innumerable times. The allowance for depletion is closely akin to the reasonable allowance for depreciation, etc., allowed by statute. The customary method of allowing depreciation is to estimate the useful life of a depreciable asset and its salvage value at the termination of its useful life, to deduct the estimated salvage value from the cost and to grant allowances each year over the estimated life so that the difference between cost and salvage value can be thus recovered. It has happened in innumerable cases that subsequent events have conclusively demonstrated that a depreciation allowance for a prior year was too large. For example, it might be estimated when a machine was acquired that its useful life would be five years, yet at the end of the five year period the machine might be still in active use. If the holding of the Court below is sound, the correct practice would be to add to the income of the year, in which it was discovered that an erroneous estimate had been made, the excessive depreciation previously allowed. Yet, although such errors have been discovered in thousands and thousands of cases, it has never been suggested that such a course could be followed. The consistent practice of the Bureau has been, if the recoverable cost has been already recouped, to deny further deductions in subsequent years, and, if there remains any recoverable cost, to decrease the rate so that over the life of the asset, as newly estimated, the remainder will be recouped.

The situation here fails to meet this Court's requirement that receipt of income or accrual of the right to receive it within the tax year is the test of taxability.

III.

But if we assume, as the Court below erroneously assumed, that gross income went untaxed in 1926, the lower Court's holding that since limitation prevented correcting the error in 1926, the adjustment is generally to be made in the later year, is clearly erroneous. Much that has been said above as to the requirement that income be received or accrue within the tax year in order to be taxable is applicable here.

In addition, it is clear that there is no element of estoppel to support the Respondent's position. There was no misrepresentation, concealment or anything which would support estoppel. Sneed reported his entire gross income in 1926. He claimed his deduction; it was denied him; he fought for it and obtained it. That is the whole story. He cannot be estopped when he attempts to retain the benefit which he thus obtained.

There is much in revenue legislation to indicate that Congress never intended the result reached by the Court below. There have always been statutes of limitation, except in the case of fraud, upon the Government's right to collect additional taxes. What possible value would those statutes be if they were applied as the Court below applied them? That is to say, in substance, that it having been ascertained in one year that an insufficient amount of income had been taxed in a previous year, but statutes of limitation prevented reopening the year in which the income was received, it is appropriate to include a corresponding amount in a later year when nothing was received by

or accrued to the taxpayer. Any such theory entirely avoids the ordinary statutes of limitation.

Congressional intention that no such result would follow is further shown by section 820 of the Revenue Act of 1938, carried forward and now *Section 3801 of the Internal Revenue Code.* The purport of this section is to mitigate the effect of limitation statutes where it has been determined that income has been reported or a deduction taken in the wrong year or vice versa. But Congress carefully limited the application of this section to errors made in the year *1932 and subsequent years;* thus clearly evidencing an intention that earlier years were to remain at rest. In the case at bar if any income was untaxed, it was income for 1926 and section 820 of the Revenue Act of 1928 forcefully shows that Congress wanted no reconsideration of tax liability for that year, or any year prior to 1932.

A change in revenue legislation first made in 1932, and carried forward in all subsequent Acts, supports the same conclusion. Prior to the passage of the Revenue Act of 1932, the rule always applied in determining the gain from the sale of a depletable interest in an oil property was that the basis for determining gain or loss from the sale was to be reduced by so much of the depletion previously allowed as was based on cost or value as of March 1, 1913, but not depletion allowed upon discovery value or upon the percentage of income basis to the extent that such allowances exceeded the depletion allowed based upon cost or March 1, 1913 value.

By section 113(b) of the Revenue Act of 1932, this

was changed to provide that the basis should be reduced by discovery or percentage depletion allowed for the year 1932, and subsequent years. This clearly indicates a congressional intention that percentage depletion allowed prior to 1932 — and the allowances here involved were made in 1926 — should not be taken into consideration in determining income for subsequent years.

The rule generally applied by the lower courts in situations comparable to that here under discussion conforms to the principle announced by this Court in *Guaranty Trust Company v. Commissioner*, 303 U. S. 493, heretofore dealt with, that receipt or accrual of income within the taxable year is the test of taxability. Some attempts have been made to vary the application of this rule by applying the doctrine of estoppel. But it is clear here that Sneed was not estopped to deny that he received income in 1936 when the 1926 leases lapsed. The case of *Helvering v. Schine Chain Theaters Inc.*, 121 Fed. (2d) 948, decided July 21, 1941, by the Second Circuit Court of Appeals, is directly in point here. It is discussed at some length in the preceding petition for certiorari. Other cases by Courts and the Board of Tax Appeals, applying the same principle, are cited in the footnotes.[19]

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[19]Commissioner v. Speyer (C. C. A. 2), 77 Fed. (2d) 824; Creasey Corp. v. Helburn (U. S. D. C., Ky.), 57 Fed. (2d) 204; Grauman's Greater Hollywood Theatre Inc., 37 B. T. A. 448; Sugar Creek Mining Company, 31 B. T. A. 344; and see, generally, the cases cited 1 Paul & Mertens, Federal Income Taxation, p. 481, Para. 11.03.

IV.

We have heretofore referred to the fact that the bonus paid for an oil and gas lease does not, as minimum royalties do, pay in advance for any specific quantity of oil or gas to be subsequently produced. Because of this, if a lessee produces any oil or gas whatsoever under the lease the property has been actually depleted and, under the Respondent's own rulings, no part of the depletion allowed with respect to a bonus can be restored when the lease terminates, and this, regardless of how small the amount of the oil or gas produced might be. The Board of Tax Appeals applied this principle in *Crabb v. Commissioner*, 41 B. T. A. 680, and, although the petition appealed upon other questions, the respondent did not.

This principle, petitioners submit, is of controlling importance here, regardless of how the Court might decide a case in which a lessor leased his entire holdings of land to one lessee and that lease terminated without any production whatsoever.

Petitioners' argument here is this:—Sneed's ranch was one property from his standpoint. It was underlain with one continuous, migratory stratum of gas, all of which, under the evidence and findings, could ultimately have been produced through any one or more wells located anywhere on the ranch, in just the same way that any one outlet to a body of water will ultimately drain off all of the water in the body that can by gravity flow into the outlet. During the term of the leases which lapsed in 1936 very large quantities of gas were produced from this ranch, and a substantial

quantity of this production came from under the areas upon which the leases lapsed.[20] Thus, during the term of these leases there was actual depletion, and consequently under the principle above announced and under the *Crabb* decision no part of the bonus depletion allowed in 1926 can be restored to income in 1936, when the leases lapsed.

The controverted point in the application of this theory is whether Sneed's ranch, for depletion purposes, was one property or whether there were from his standpoint as many different properties as there were separate leases. The statute has never defined "the property." It merely provides that in the case of oil and gas wells the allowance for depletion shall be 27½ per cent of the gross income from "the property" and that in the case of leases all allowances for depletion shall be equitably apportioned between the lessor and lessee. The definition of "the property" has varied to some extent in various regulations. Under the earlier discovery depletion provisions the property to be revalued extended "to the limit of the taxpayer's private bounding lines, but not beyond the limits of the proven area as heretofore provided."[21] Under this definition and the established fact that the gas stratum extended under the entire ranch, it would appear that the entire ranch was one property. In other Regulations it is stated "In general 'the property,' as the term is used in section 204(c)(2) of this Article re-

[20]R. 26-27, 56-58.

[21]Art. 220(a)(3) Reg. 45, (R. A. 1918); Arts. 201(c), 214 and 220(a)(3) of Reg. 62 (R. A. 1921) and Reg. 65 (R. A. 1924).

fers to the separate tracts or leases of the taxpayer."[22] Sneed had no leases. The tract of land which he owned was the entire ranch. In other Regulations[23] "the property" is defined as "the mineral deposit, the development and plant necessary for its extraction and so much of the surface of the land *as is reasonably expected to be underlaid with the mineral.*" Under this definition it is clear that Sneed's entire ranch would, from his standpoint, be "the property."

Beginning with Regulations 45 (1918 Act) and continuing through Regulations 69 (1926 Act), the later Regulations being the one under which Sneed's allowances were made for 1926, it was provided that the recoverable oil belonging to the taxpayer should be estimated for each property separately, but that "in the case of gas properties the depletion allowance for each pool shall be computed by using the combined capital account returnable through depletion of all the tracts of gas land owned by the taxpayer in the pool and the average decline of rock pressure of all the taxpayer's wells in such pool, etc."[24] Since it is definitely established that the gas pool from which the production came extended under all of Sneed's ranch and beyond, this Regulation would support Sneed's position here even though each lease which he made might be considered a separate property.

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[22]Art. 221 of Reg. 69 (R. A. 1926).

[23]Art. 221 of Reg. 74 (R. A. 1928).

[24]Art. 214(a) of Reg. 45 (R. A. 1918); Art. 214 of Reg. 62 (R. A. 1921); Art. 215 of Reg. 65 (R. A. 1925); Art. 215 of Reg. 69 (R. A. 1926), Appendix, p. 51, infra.

It is reasonable and fair to treat Sneed's ranch as one property. His royalties were the same regardless of what portion of the ranch the producing wells were located upon. Any well on his ranch drained from the entire pool. The fortuitous circumstance that he made several leases should not decrease the aggregate of his depeltion allowances beyond what they would be had he made only one lease for an aggregate bonus equal to all of the bonuses received and this lease had been followed by the development and production which has actually occurred upon his entire ranch. The Court below met this by stating:

> "The actual depletion of gas under these lands through wells drilled under other leases is compensated by the depletion allowances made at those wells. There would be a double allowance if it were also allowed here."

This entirely overlooks the fundamental theory with respect to percentage depletion allowances. Percentage depletion is not measured by the quantity of oil or gas produced, but is measured by the taxpayer's gross income from the property. So when some of the gas which was actually under the areas as to which the leases lapsed was extracted through wells located elsewhere on the ranch and Sneed received his ordinary royalties thereon, these royalties were only a part of his gross income from the property. He was of course entitled to depletion with respect to the portion of his gross income represented by ordinary royalties, but he was none the less entitled to depletion with respect to every other item of gross income from his property. What Sneed claims here is no more a double deduction

than it is a double deduction to allow a lessor depletion with respect to an advance royalty or bonus, and then allow him depletion on his ordinary royalties when he receives them under that lease. His aggregate allowances will never exceed 27½ per cent of his gross income from the property, and anything less will deprive him of a portion of the statutory allowance which Congress clearly intended to grant him, and which this Court has upheld in the *Herring* and many other cases.

So, we submit that Sneed's ranch was one property; it was actually depleted during the life of the leases which lapsed in 1936, and , therefore under the principles here discussed, no portion of the depletion allowed in 1926 can be restored to income, and this is true regardless of how the question might be decided had there been no production whatsoever during the life of these leases from other portions of the ranch.

V.

Under this Court's decision in the *Herring case*, percentage depletion with respect to a lease bonus is to be allowed in the year the bonus is received, regardless of when there is actual production from the property. The reasoning is this: the basis for the allowance is gross income from the property. Advance royalties are a part of that gross income. The allowance is to be made annually upon this basis, and if it is not made as to each item of gross income from the property when it is received, the deficiency cannot be made up in a subsequent year, no matter how great the production and subsequent depletion.

When this principle is considered in the light of the fact that nowhere in the statute or Regulations is there any limitation upon the method by which a lessor might realize gross income from the property, or any requirement that each leasing transaction should be considered separate from the others, it is clear that the holding of the Court below will, under the very unusual facts in this case, certainly deprive Sneed of a portion of the allowances to which the statute entitles him.

The unusual facts are these: It was known with absolute certainty during the life of the lapsed leases, and when they lapsed, that there were commercially productive quantities of gas under each area. New leases were made on each area and it was certain that subsequent to 1936 there would be development upon these particular areas and subsequent production therefrom.

So, since there is no authority in statute or regulations for the proposition that the lessor's percentage depletion allowances are limited by the gross income which he receives under a particular lease, rather than by his "gross income from the property," Respondent's action and the decision of the Court below permanently deprived Sneed of a portion of the allowances granted him by statute. Here again, this result is a clear demonstration that the decision below was erroneous, regardless of how the basic question might be decided when only the ordinary circumstances were present.

The discussion of this point by the Court below is not convincing. The Court said, in part:

"The bonuses in question are, it is argued, 'in-

> come from the property' under the statute whether in 1926 or 1936. But in 1936 they did not, as was assumed in 1926, represent any depletion."

The correct statement is that, while there had not been any production from these areas in 1936, it was even more certain then than it was in 1926, that there would ultimately be production from, and actual depletion of, them. The Court also emphasized here the statutory phrase "in the case of oil and gas wells." But the presence of an oil and gas well is no more necessary to retain the depletion allowance previously granted than it was to authorize it in the first place, and that question was finally settled by this Court in the *Herring case*. It may be, as the Court below suggested, "unreasonable to permit an allowance for depletion when no well is ever opened." But it is even more unreasonable to deny permanently an allowance for depletion with respect to an advance royalty when it is certain that wells will be opened and will produce in the future, and when the statute bases the allowance on the entire gross income from the property and not under one particular lease, and when the Regulations construe these provisions to allow "annual depletion and depreciation deductions which, in the aggregate, will return to him the cost or other basis of such property * * *." Reg. 94, Art. 23(m)-1.

CONCLUSION

It is respectfully submitted that the decision below is erroneous; deals with an important question of federal law; conflicts with controlling decisions of this

Court and with decisions of other Circuit Courts of Appeals, and that the Petition for Certiorari should be granted and the decision below reversed.

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